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Public Hearing to Review the Tobacco Quota Buyout
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Thank you Mr. Chairman and members of the Committee for allowing me this opportunity to testify before you today. My name is Everett Gee and I am here on behalf of my family's small tobacco manufacturing business, S&M Brands, Inc., located in Keysville, Virginia. I am honored to sit before you and speak about the importance of protecting small manufacturers during the formulation of any Federal legislation regarding the buyout of tobacco quota, my opinions on how post tobacco buyout policy should be shaped and my thoughts about the possibility of the Food and Drug Administration (FDA) being given regulatory authority over the tobacco industry and the manufacturing and sales of cigarettes.

Company History

S&M Brands, Inc. is a family-owned business that was founded by father and son Mac and Steven Bailey. The Baileys represent fourth and fifth generation of tobacco farmers from Southern Virginia. In 1994 the Baileys decided to enter into the business side of the tobacco world, and founded S&M Brands, Inc., the maker of Bailey's® and Tahoe® Cigarettes ("Bailey's"). And today, the Baileys still raise tobacco and their experience as farmers and small tobacco manufacturers give them a unique perspective with regard to the issues being discussed here today.

Bailey's had been a lifelong dream of Mac Bailey. Mac was tired of the American tobacco farmer bearing the financial burden of misdeeds by the large cigarette manufacturers. Each year the Baileys saw a decrease in the amount of American-grown tobacco that the large tobacco companies like Philip Morris, RJR and the rest of "Big Tobacco" purchased. Big Tobacco was purchasing increased amounts of foreign tobacco, abandoning the U.S. grower to save a few pennies.

Mac and Steven Bailey were determined from the beginning never to engage in such activity. It is the sole reason that the company has kept its commitment to the American tobacco farmer and purchases only 100% American-grown flue and burley tobaccos. Our mission statement has always been to sell "an honest smoke at an honest price."

Bailey's has grown from a start-up company that sold its cigarettes to small country stores in the Keysville, Virginia area to a company that sells cigarettes to retailers and wholesalers in Virginia, Delaware, North Carolina, West Virginia, South Carolina, Kentucky, Tennessee, and Georgia. Since 2000, Bailey's has paid over \$100 million dollars in federal, state, and local taxes. The company gives generously in charitable contributions annually. It has become a vital employer in the Keysville area, an economically depressed area in the Commonwealth, maintaining approximately 200 jobs in that rural area. Recently, two large and one small manufacturer closed in our area, taking away hundreds of jobs. This unfortunate event has made the company even further dedicated to continuing to grow and provide good paying jobs to our citizens.

Responsible Marketing and Disclosures

Bailey's complies with all marketing laws applicable to its products. Bailey's does not market to youth. Tobacco is an adult product and the adult consumer is our consumer. Bailey's markets to adult consumers who love the outdoors.

Bailey's advertising features the trademarked Bailey's tobacco barn, symbolic of the fact that Mac is a tobacco farmer and his tobacco is used in the cigarettes. Bailey's ads appeal to the working man and woman who choose to smoke. Our information shows our smokers are middle-aged working Americans who appreciate a quality product at an affordable price.

Bailey's has always been open about the adverse effects of smoking. Although we were not required to do so, Bailey's lists cigarette additives on the internet. We believe in full disclosure so that adults can make an informed decision about smoking.

Master Settlement Agreement

In 1998, Big Tobacco announced a global settlement with 46 states and various territories known as the Master Settlement Agreement ("MSA"). In exchange for billions of dollars and some voluntary marketing restrictions, Big Tobacco received a release from its past conduct that had brought about suits for fraud, punitive damages, RICO, and attorneys' fees.

Before the ink was dry on the settlement, an attorney for Big Tobacco called Bailey's demanding that the company sign on to the MSA and gave us 48 hours to decide. At that time, Bailey's had not even seen the document. However, upon reading the MSA, the decision not to join was an easy one.

Of course, new manufacturers such as Bailey's were not sued by the states, having no part in Big Tobacco's defrauding of the American public. Even existing smaller companies were not at the settlement table. If Bailey's had signed the MSA, it would have effectively admitted to fraudulent conduct that it did not commit and would pay damages for such conduct. Furthermore, Bailey's would have had to forfeit rights guaranteed by the Constitution to advertise its legal product.

Mac and Steven Bailey wondered how Big Tobacco could afford to pay billions of dollars to the states without imposing massive price increases on their cigarettes. With price increases, Bailey's thought it could finally compete with the large companies. However, Big Tobacco had already resolved their problem.

As a part of the MSA, Big Tobacco had the states promise to pass "Model Statutes." If a state did not pass the "Model Statute" it would receive decreased payments. The legislation requires a company that did not sign the MSA, like Bailey's, to escrow a significant amount of money per cigarette sold (thus artificially increasing the cost of a pack) so that Big Tobacco would not lose their market share. This is not supposition—the MSA expressly states that the escrow would "level the playing field" so that newer companies, innocent of wrongdoing, cannot compete on the basis of price.

Bailey's worked hard to convince the Virginia legislature to reject this unfair statute, but we were unsuccessful. Now the price of Bailey's cigarettes has been inflated, so that Big Tobacco can pass the costs of the settlement with the states to the innocent smoker. The scheme has worked beautifully and to the detriment of Bailey's. Big Tobacco has lost little market share. Big Tobacco's profits were at record levels last year. Never before have the states sued an industry for massive wrongdoing, and then assisted the same wrongdoers via legislation to make sure that no business is lost to new, innocent competitors. The states have in effect created a tobacco "cartel" made up of Big Tobacco, making new entry almost impossible. It is doubtful that Bailey's could have even started a company in 1999 or 2000, when the escrow requirement came into effect.

Today, Big Tobacco is going back to the states to increase the escrow burden on small manufacturers like Bailey's. This increase is being sought even though the MSA mandates that the escrow statute cannot be changed. Our company is fighting to stay afloat in the aftermath of these statutes being enacted, as they are designed to shut down regional companies that have acted in full compliance with the law.

Tobacco Quota Buyout

Concerning the various tobacco quota buyout proposals, Bailey's has a unique perspective because the company has not only an interest as a manufacturer, but also the longer-term interests of farmers. Certainly, the tobacco growers have suffered greatly with reduced quota in the past few years. So with mixed feelings about a buyout, Bailey's will comment on what a buyout enacted by Congress should look like.

We also would like to express our concern regarding using a tax increase as the solution to this issue. If you are looking for steady revenue streams to fund the tobacco quota buyout, increasing the excise tax is one way; however, we certainly are not advocating that we support higher taxes as a way to stabilize small business or the economy.

Indeed, there have been discussions about the tobacco manufacturing industry funding a buyout. If this is the law, small tobacco companies have three main interests: (1) that the funding be

fairly and equitably charged, meaning each company, large and small, pays the same per cigarette charge; (2) that the payment collection mechanism ensures that all companies pay; and (3) that the quota buyout is a federal issue and should not be tied in any way to the multi-state Master Settlement Agreement with big tobacco.

If an increase in the excise tax becomes the law, we must ensure that the payment is fair and that all manufacturers pay an amount determined based on a per stick charge and then added to the current Federal Excise tax. This method would guarantee that all companies would pay equitably based on their respective market share, and it would protect small companies from being drained by inflated payments.

As for the payment mechanism, Congress should avoid setting up the collection of any industry assessment that does not guarantee payment up front. The states have a very difficult time collecting MSA monies due particularly from foreign manufacturers that can come and go at will. These companies can undercut legitimate U.S. companies large and small because the price of their cigarettes does not reflect the escrow payments legally required. Sending such a company a bill at the end of the year for its market share will result in an unpaid bill, again shorting the farmer of the monies promised for the buyout.

Congress already has in place an up-front payment mechanism, the Federal Excise tax on cigarettes. Imported cigarettes must pay this tax up front before being released into commerce. The necessary increase with a sunset provision will make everyone pay their fair share.

Finally, the buyout of the tobacco quota system is under the jurisdiction of the federal government and it should not be tied into the MSA with the states. More importantly, Big Tobacco should not receive credit for paying state litigation settlement partly based on its decades of misconduct when the issue is the buyout of the federal quota system. Any credit given Big Tobacco would jeopardize the ability to pay the farmers at all. A price disparity would drive little tobacco companies to the brink of ruin, and the contribution expected for the farmers would not come about. It is certainly not sound public policy to create legislation that will decide market winners and losers thereby favoring the interests of multi-conglomerate international companies over family-owned small businesses.

FDA Regulation

In the area of FDA regulation of tobacco, Bailey's recognizes that FDA regulation has not been necessary since the beginning of cigarette manufacturing and therefore, it should not start now. Bailey's also believes that the FDA and a quota buyout are wholly separate issues that should not be intermingled. We believe that the only benefit that would be brought about by FDA regulation is the protection of market share by big tobacco companies that favor such regulation as it would be cost prohibitive to other current and future big and small tobacco companies thereby creating a federal barrier to entry for current and future competitors of those that favor FDA. In particular, Bailey's does not support FDA regulation as proposed by Philip Morris or by numerous Congressmen and Senators because:

1. Almost everything that is being called for can be done by agencies that already regulate tobacco or through the enforcement of existing state law:
 - (a) Youth smoking prevention - *The FTC, the MSA, and enforcement of existing state laws.*
 - (b) Design and regulation of ingredient and constituent testing and disclosure - *The FTC and HHS.*
 - (c) Design and regulation of the text of health warnings on cigarette packages and in advertisements - *The FTC.*
 - (d) Definition and regulation of the use of terms like "light" and "ultra light" - *The FTC.*
 - (e) Definition and regulation of standards for, and responsible marketing of, any reduced risk cigarettes - *The FTC.*
2. FDA regulation of the scope proposed by some (product performance standards testing beyond what is proposed in 1.(b) above) is designed to be or will have the effect of being cost prohibitive for the small manufacturer and therefore lock in market share of the leading major tobacco company that favors this new regulation.
3. Philip Morris is calling for FDA regulation because by doing so they advance their own public relations efforts. The government should not be a vehicle for Philip Morris to achieve its competitive agenda.
4. The MSA put the states in the tobacco business. They now have a financial interest in preserving the market share of the signatories to that document, Big Tobacco, because reduced market share means reduced payments to the states. The federal government should not compound the problem by allowing itself - through the FDA - to be used as a vehicle to further cement any company's market share and protect the states' "investment." It is not a legitimate governmental purpose to lock in a tobacco cartel of favored, large companies, making competition by new, small companies impossible.
5. The FDA should focus on its primary business. It is widely acknowledged that the FDA approval process for new drugs is not as fast as it could or should be.
6. Once the FDA has regulatory authority, regulation over smoking is most removed from the people, as represented by Congress, and given to nameless, faceless regulators. Rarely does a governmental agency resist the temptation to expand its power. Once the proverbial genie is out of the bottle, so to speak, the tobacco industry will be subject to ever changing restrictions dictated by future political considerations. Yes, Bailey's wants to stay in business. But no rational person wants

to create a black market for cigarettes, or make our consumers turn to foreign cigarette companies where no quality control can be assured.

7. Philip Morris claims to want to “level the playing field” in advertising. This is a crass attempt to impose on new, innocent companies, the marketing restrictions Big Tobacco was forced to concede to escape jury trials in the 50 states. Big Tobacco voluntarily waived constitutional rights to advertise to settle litigation, a choice it made. However, Congress should not bail Big Tobacco out, and lock in its market share, as the states have done by passing escrow statutes to inflate the price of cigarettes made by new companies like Bailey’s.

If there must be FDA regulation, Bailey’s believes that it should take the following provisions into consideration as it is formulated:

1. The rationale behind FDA regulation should be to ensure safer cigarettes only through accommodating companies that want to sell a “reduced risk” product. However, companies marketing traditional tobacco cigarettes should not have to pay for chemical analysis of products that have been tested and studied for years. The mandated warnings already put the smoker on notice of the danger. Allowing the FDA or any agency to start adjusting ingredients on traditional cigarettes will mean that only the largest will survive, because it is those companies that can pay the exorbitant costs associated with these procedures;
2. There must be an exemption for small companies under 2% of the market share;
3. There must be regulation for foreign companies, as American companies cannot compete fairly with those who are allowed to sell their tobacco to our companies yet are not subject to our laws and regulation;
4. Companies shall be given a reasonable timeframe in which they can implement any necessary changes;
5. The Government should offer grants to offset the costs of the requirements, as such cost would put most of the small businesses out of business;
6. Small manufacturers should receive assistance from the Government via specialists to ensure that we are compliant with any new regulations; and
7. Small manufacturers should have input in the standards as they are formulated and written into regulation.

Cigarettes are a legal product. It is un-American to stifle legitimate competition from the small company to satisfy the desires of the largest companies.

Conclusion

In conclusion, Bailey’s is a small business. We are regular folks, small farmers, trying to keep our business afloat here in Southern Virginia. Our voice is not strong compared to those of multi-conglomerate international companies, but our cause is just. We are respectfully asking Congress and the state legislatures to treat small tobacco fairly. We don’t believe a smoking cartel in America dominated by three or four big companies is the right or the fair solution. You

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have got to keep room for small businesses in America. Your decisions over the next few years will determine if the American dream continues for the folks at Bailey's.

Thank you, Mr. Chairman. And thank you to all of the Committee and the Committee staff for the opportunity to share with you my observations on this important issue today.